Allocating Losses from Forged Indorsements between Negligent Drawers and Depositary Banks: *Girard Bank v. Mount Holly State Bank*

I. INTRODUCTION

Articles Three and Four of the Uniform Commercial Code provide intricate machinery for allocating losses caused by the forgery of signatures on negotiable instruments. Instances arise, however, that are not expressly covered by the Code. In these situations, courts are called upon to interpret the law in the absence of any legislative directive. In developing this common law, the courts often have followed pre-Code decisions without determining the appropriateness of their application of such precedent in the modern commercial context.[1] As might be expected, the results frequently are unjust.

The facts of *Girard Bank v. Mount Holly State Bank*[2] presented the federal district court with such a situation. In *Girard* it was alleged that an employee of a negligent drawer of a check had stolen and negotiated the check by forging the indorsement of the payee's name.[3] The check was deposited in a collecting bank,[4] Mount Holly State Bank, and later paid by the drawee, Girard Bank. Rather than charge the amount of the check to its customer/drawer, however, Girard sued Mount Holly for breach of its warranty of good title, which Mount Holly had made pursuant to the provisions of the Uniform Commercial Code.[5] Because the Code does not explicitly provide any method for a collecting bank to pass this liability on to the negligent drawer, Mount Holly ordinarily would have been forced to bear this loss.

Nevertheless, the court in *Girard* decided to transfer this loss from the innocent collecting bank to the negligent drawer. In so doing, the court considered two possible alternative solutions to the lack of remedy problem: first, a requirement that the drawee assert all possible negligence defenses against the drawer of a check before proceeding against prior collecting banks on a breach of warranty action; or second, creation of a cause of action in common law negligence in favor of the collecting bank

1. *See* Gilmore, *Formalism and the Law of Negotiable Instruments*, 13 CREIGHTON L. REV. 441 (1979). *But see* Scott, *The Risk Fixers*, 91 HARV. L. REV. 737 (1978).

2. 474 F.Supp. 1225 (D.N.J. 1979).

3. *Id.* at 1229.

4. "Depositary bank" is defined in § 4-105 of the U.C.C. as the "first bank to which an item is transferred for collection." "Collecting bank" is also defined there as "any bank handling the item for collection except the payor bank." U.C.C. § 4-105. Throughout this Case Comment, unless otherwise indicated, collecting bank will be used to refer both to any collecting bank and to the deopsitary bank. When differentiation of the terms is intended, the text will refer to the depositary bank specifically.

5. *See* note 23 and accompanying text *infra*.

and against the drawer. In reaching its decision, the court adopted the latter possibility.

This Case Comment will briefly consider the system by which losses caused by forged indorsements on checks[6] are allocated under both pre-Code law and the Uniform Commercial Code and will explain how the operation of the Code provisions results in a lack of remedy for a collecting bank that finds itself in a *Girard*-type situation. The two solutions entertained by the court in *Girard* will be analyzed in light of the objectives of a system of loss allocation for negotiable instruments. Finally, while supporting the court's decision to impose liability for forged indorsements upon the negligent drawer, this Case Comment will demonstrate that the alternative not adopted by the court, requiring the drawee to assert the drawer's negligence, would have been the preferable solution.

II. THE SYSTEM OF ALLOCATING LOSSES CAUSED BY FORGED INDORSEMENTS: AN OVERVIEW OF PRE-CODE AND U.C.C. RULES

The losses caused by forged indorsements on checks under both the Code and pre-Code law usually fall upon the first solvent party in the chain of transferors after the forger.[7] The manner in which a party handles a check, or his lack of good faith in so doing, however, may alter this general rule of loss allocation. In these instances the loss occasioned by the forgery usually will fall upon that party.[8]

Similarly, when a party is negligent in handling a check, the loss caused by the forged indorsement usually will fall upon that party.[9] The rule of "allocation by negligence" is altered, however, by the inability of a party to assert the other's negligence as a factor in determining liability.[10] This inability arises in two ways: first, a jurisdiction may not allow a defendant-transferor to assert another's negligence as a defense against the plaintiff-transferee;[11] and second, the forgery having been discovered and the loss established, a jurisdiction may not allow a party to pass his loss back onto prior handlers of the instrument.[12] In either situation, the loss, occasioned by another's negligence, will be borne by a relatively innocent party.

A. *The General Rule*

The system of loss allocation in the case of forged indorsements was designed, under the pre-Code law, to place the resulting loss on the forger,

6. Losses on bank checks caused by the forgery of the drawer's signature will not be considered; nor will losses caused by the forgery of both the drawer's signature and a necessary indorsement.

7. *See* text accompanying notes 13-23 *infra*.

8. *See* text accompanying notes 24-30 *infra*.

9. *See* text accompanying notes 31-40 *infra*.

10. *See* text accompanying notes 41-51 *infra*.

11. *Id.*

12. *Id.*

or in cases of his unavailability or unsuitability for suit, upon the first person to trust the forger.[13] This was accomplished by refusing to permit a drawee bank that had paid a check over a forged indorsement to charge the account of the drawer for the amount of the check since the drawee had not paid the instrument "in strictest accordance with the direction of its depositor."[14] Recourse could be had, however, by the drawee bank against the person or bank who presented the check for payment. Such recovery was justified by one of several theories, the two most preeminent being that either a mistake of fact induced the payment[15] or the person presenting the instrument had breached a warranty of good title.[16] The warranty breached in these situations was either implied upon presentment or imposed by sections 65 and 66 of the Negotiable Instruments Law.[17] Thus the loss occasioned by the payment of the check over the forged indorsement worked its way back along the chain of transferors to the first person to trust the forger, as the forgers themselves are notoriously immune to judgments. The policy of this loss allocation system is clear: the person taking the check from the forger is often in the best position to prevent the forgery by requiring identification or by knowing the person with whom he is dealing.[18] In addition, while a drawee bank is bound to know the signatures of its own customers,[19] it could not be expected to examine and recognize the authenticity of every indorsement signature on every check drawn by its customers.[20]

An identical allocation of losses from forged indorsements results under the provisions of the Uniform Commercial Code. When a drawee pays a check on which a necessary indorsement is forged,[21] the drawer, absent other circumstances, may compel the drawee bank to recredit the

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13. Note, *Allocation of Losses From Check Forgeries Under the Law of Negotiable Instruments and the Uniform Commercial Code*, 62 YALE L.J. 417, 421 (1953).

14. Callaway v. Hamilton Nat'l Bank, 195 F.2d 556, 560 (D.C. Cir. 1952).

15. Canal Bank v. Bank of Albany, 1 Hill 287 (N.Y. 1841).

16. Security Sav. Bank v. First Nat'l Bank, 106 F.2d 542 (6th Cir. 1939); Judge v. West Philadelphia Title & Trust Co., 68 Pa. Super. 310 (1917).

17. Security Sav. Bank v. First Nat'l Bank, 106 F.2d 542 (6th Cir. 1939); Judge v. West Philadelphia Title & Trust Co., 68 Pa. Super. 310 (1917).

18. H. BAILEY, BRADY ON BANK CHECKS § 23.20 (5th ed. 1979).

19. Price v. Neal, 97 Eng. Rep. 871 (K.B. 1762).

20. BAILEY, *supra* note 18, at § 23.20.

21. Not all indorsements are necessary to the proper negotiation of a check. When an instrument by its terms is payable to the order or assigns of any person specified on the instrument with reasonable certainty, when it is payable to a person or his order, or when it is conspicuously designated on its face as "exchange" or the like and names a payee it is "order" paper. U.C.C. § 3-110. Such an instrument may be negotiated in the first instance only by the indorsement of and delivery from the payee. U.C.C. § 3-202. If the item is so transferred the transferee becomes a "holder" of the instrument. U.C.C. § 1-201(20). If an instrument is payable to bearer, to cash, or to an otherwise non-specified payee, the instrument is "bearer" paper and can be negotiated by delivery alone. U.C.C. §§ 3-111, 3-202. Any transferee of a bearer instrument may be a holder. U.C.C. § 1-201(20). Finally, an indorsement that specifies the person to whom or to whose order the instrument is payable is a special indorsement and requires the indorsement of the person so specified for further negotiation. U.C.C. § 3-204. Thus, the indorsements of the payee on order paper and of the special indorsee on either order or bearer paper are necessary for a transferee to acquire good title to the instrument through negotiation.

drawer's account since the item is "not properly payable."[22] This loss of the drawee may, however, be passed back to previous indorsers by actions on the warranties of good title that the indorsers make to the drawee pursuant to sections 3-417 and 4-207 of the Code.[23] Thus, the loss will finally come to

22. Under U.C.C. § 4-401, a bank may charge against its customer's account only items that are properly payable. *See* J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 15-3 at 585 (2d ed. 1980). Payment of an instrument on which a necessary indorsement is forged constitutes payment of an item "not properly payable" since any unauthorized signature is wholly inoperative as the signature of the person whose name is signed unless a ratification or preclusion occurs. U.C.C. § 3-404.

23. U.C.C. §§ 3-417(1) (a), 4-207(1) (a). The section 4-207(1) warranties are made by each customer or collecting bank who obtains payment or acceptance of the item and by each prior customer and collecting bank to the payor bank or other payor who in good faith pays or accepts the item. The section 3-417 warranties are made by any person who obtains payment or acceptance of the instrument and by any prior transferor to a person who in good faith pays or accepts it. The differences in the application of the two sections are not important to this discussion but are examined in WHITE & SUMMERS, *supra* note 22, at 600 n.47. The relevant portions of the texts of these sections are set out below.

§ 3-417. Warranties on Presentment and Transfer

(1) Any person who obtains payment or acceptance and any prior transferor warrants to a person who in good faith pays or accepts that

(a) he has a good title to the instrument or is authorized to obtain payment or acceptance on behalf of one who has a good title; and

(b) he has no knowledge that the signature of the maker or drawer is unauthorized, except that this warranty is not given by a holder in due course acting in good faith

(i) to a maker with respect to the maker's own signature; or

(ii) to a drawer with respect to the drawer's own signature, whether or not the drawer is also the drawee; or

(iii) to an acceptor of a draft if the holder in due course took the draft after the acceptance or obtained the acceptance without knowledge that the drawer's signature was unauthorized; and

(c) the instrument has not been materially altered, except that this warranty is not given by a holder in due course acting in good faith

(i) to the maker of a note; or

(ii) to the drawer of a draft whether or not the drawer is also the drawee; or

(iii) to the acceptor of a draft with respect to an alteration made prior to the acceptance if the holder in due course took the draft after the acceptance, even though the acceptance provided "payable as originally drawn" or equivalent terms; or

(iv) to the acceptor of a draft with respect to an alteration made after the acceptance.

§ 4-207. Warranties of Customer and Collecting Bank on Transfer or Presentmentof Items; Time for Claims

(1) Each customer or collecting bank who obtains payment or acceptance of an item and each prior customer and collecting bank warrants to the payor bank or other payor who in good faith pays or accepts the item that

(a) he has a good title to the item or is authorized to obtain payment or acceptance on behalf of one who has a good title; and

(b) he has no knowledge that the signature of the maker or drawer is unauthorized, except that this warranty is not given by any customer or collecting bank that is a holder in due course and acts in good faith

(i) to a maker with respect to the maker's own signature; or

(ii) to a drawer with respect to the drawer's own signature, whether or not the drawer is also the drawee; or

(iii) to an acceptor of an item if the holder in due course took the item after the acceptance or obtained the acceptance without knowledge that the drawer's signature was unauthorized; and

(c) the item has not been materially altered, except that this warranty is not given by any customer or collecting bank that is a holder in due course and acts in good faith

(i) to the maker of a note; or

(ii) to the drawer of a draft whether or not the drawer is also the drawee; or

rest upon the forger of the indorsement or the first solvent party after the forger.

B. *Estoppel and Lack of Good Faith*

Acts of the parties in uttering or handling an instrument may alter the ordinary application of the above rules for allocation of losses caused by forged indorsements of checks. Many of the Code sections in this area are merely statutory enshrinements of the pre-Code rules. For example, section 3-404 of the Code recognizes that a person may ratify an unauthorized signature for any purpose under Article Three or be precluded from denying the authority of the signature.[24] Therefore, the signature would be valid to the extent of its effect as a signature.[25] While it was clear that unauthorized signatures could be ratified under pre-Code law, there was a divergence of opinion regarding whether forgeries could be ratified.[26] Subsection (2) of 3-404 was intended by the Code drafters to adopt the rule that both types of signatures could be ratified.[27] Thus, when a drawee bank pays a check over a forged indorsement that the named person had ratified or is precluded from denying, as in the case of apparent agency, the loss falls upon the person ratifying or so precluded instead of the person responsible for the unauthorized or forged signature. Section 3-405 describes another situation in which a person's actions affect the allocation of loss. This section, which is an enlargement of the imposture rules contained in section 9(3) of the Negotiable Instruments Law, enumerates three situations in which an indorsement by any person in the name of the named payee is effective to pass title to the instrument.[28] In each of these enumerated instances, the maker or drawer has been duped into issuing the instrument. When this occurs, the drawer of the check will usually bear the loss because the drawee normally will charge the drawer's account for the item and the drawer will be unable to assert effectively that the item was not properly payable.

Finally, when the drawee lacks good faith in paying or accepting an instrument, the Code prevents the passing of its loss on the unauthorized

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(iii) to the acceptor of an item with respect to an alteration made prior to the acceptance if the holder in due course took the item after the acceptance, even though the acceptance provided "payable as originally drawn" or equivalent terms; or

(iv) to the acceptor of an item with respect to an alteration made after the acceptance.

These warranties run with the item so that a bank can sue a remote transferor directly and thus avoid a multiplicity of suits and any problems caused by, for example, the insolvency of any intermediate transferor. U.C.C. § 3-417, comment 8; § 4-207, comment 2.

24. U.C.C. § 3-404.

25. U.C.C. § 3-404, comment 3.

26. *Uniform Negotiable Instruments Law* § 23 (superseded 1951); Annot., 150 A.L.R. 978 (1944).

27. U.C.C. § 3-404, comment 3.

28. U.C.C. § 3-405(1), and Official Comments thereunder.

indorsement to prior transferors.[29] Such transferors make their warranties only to persons who pay or accept the instrument in good faith.[30]

C. *Effect of Negligence on Loss Allocation*

Under pre-Code law, the rules concerning allocation of losses were also altered when a person was negligent in dealing with a check. For example, if a drawer were negligent in the issuance of a check, the drawee may be excused from paying out the drawer's funds in an unauthorized manner.[31] Similarly, the negligence of the drawee bank precluded its ability under pre-Code law to charge the drawer for payment of a check over a forged indorsement or to recover that payment from prior transferors of the instrument.[32]

The Code's system of loss allocation when negligence is present is closely analogous to pre-Code law.[33] If the drawer's negligence substantially contributes to the making of an unauthorized signature on the instrument the drawer would be precluded from asserting that unauthorized signature against a drawee who pays the instrument in good faith and in accordance with reasonable commercial standards.[34] Although this rule was not codified in the Uniform Negotiable Instruments Law (NIL), it is a direct outgrowth of the doctrine of *Young v. Grote*.[35] In that case a man going abroad left checks with his wife, which she filled out in such a manner that they were easily altered. The court held that leaving checks with a woman rather than a man of business was negligent.[36] More broadly stated, the court's holding was that "a drawer who so negligently draws an instrument as to facilitate its material alteration is liable to a drawee who pays the altered instrument in good faith."[37]

Similarly, section 4-406 of the Code had no direct predecessor in the

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29. U.C.C. § 3-417(1), § 4-207(1).

30. *Id.*

31. Young v. Grote, 130 Eng. Rep. 764 (C.P. 1827). For a discussion of this and other instances in which a drawer's negligence defeats his claim against the drawee under pre-Code law, *see* Whaley, *Negligence and Negotiable Instruments* 53 N.C. L. REV. 1, 4 (1975). *See also* Annot., 39 A.L.R. 2d 641 (1955).

32. First Nat'l Bank v. Guaranteed State Bank, 106 Okla. 85, 233 P. 183 (1925); National Bank of Commerce v. First Nat'l Bank, 51 Okla. 787, 152 P. 596 (1915); *Cf.* Frankini v. Bank of America Nat'l Trust & Sav. Ass'n, 31 Cal. App. 2d 666, 88 P.2d 790 (1939) (instrument contained forgeries of both the drawer and payee's names.)

33. Note, *supra* note 13, at 461.

34. U.C.C. § 3-406. The full text of that section reads:

> § 3-406. Negligence Contributing to Alteration or Unauthorized Signature
>
> Any person who by his negligence substantially contributes to a material alteration of the instrument or to the making of an unauthorized signature is precluded from asserting the alteration or lack of authority against a holder in due course or against a drawee or other payor who pays the instrument in good faith and in accordance with the reasonable commercial standards of the drawee's or payor's business.

35. 130 Eng. Rep. 764 (C.P. 1827).

36. *Id.* at 767.

37. U.C.C. § 3-406, comment 1.

NIL. Instead it replaced various state statutes dealing with like problems.[38] This section imposes a duty upon drawers to examine their bank statements within a certain time limit.[39] Accordingly, it precludes drawers from asserting certain forgeries and alterations against a drawee bank that observes reasonable commercial standards when those drawers fail to examine their statement within the designated time limits.

In each of the above situations, absent other circumstances, the loss from a forged indorsement shifts to the "negligent" drawer, rather than to some other person. Although the drawer did not intend payment, he would be unable to force the drawee to recredit his account and would remain liable to the true payee on the underlying obligation.[40]

Although the negligence of the drawer of a check is often available to the drawee as a defense against a suit by the drawer charging improper payment of the check, that negligence does not necessarily provide a defense to other parties upon whom liability might be thrust. Under pre-Code law the drawer's negligence generally was not available to a collecting bank as a defense when sued by the drawee bank or other subsequent transferee of the instrument.[41] It is not clear, however, whether a defense against the drawee based upon the negligence of the drawer is unavailable to a collecting bank under the Code. Some commentators maintain that the pre-Code rule of unavailability of defenses is clearly continued in the Code.[42] Section 4-406 unequivocally requires that, when a drawer complains of improper payment, the drawee must raise any defenses based upon the customer's failure to examine his statement promptly or upon the time limits for reporting unauthorized signatures, indorsements, or alterations in order to preserve certain warranty actions against prior transferors.[43] It is not certain, however, whether other defenses, such as the drawer's negligent issuance that leads to a material alteration, need be raised. The official comments indicate that the drafters of Article Four intended to limit the scope of section 4-406(5) to the defenses enumerated in that section.[44] The drafters of those comments recognized that while a similar principle might be applied to other defenses, they did not intend to extend the rule to those situations by their drafting of section 4-406.[45]

38. U.C.C. § 4-406, comment 1.

39. *See* notes 65-85 and accompanying text *infra*.

40. U.C.C. § 3-804 allows recovery by the true owner of a stolen instrument from anyone liable thereon "upon due proof of his ownership, the facts which prevent his production of the instrument and its terms."

41. American Exch. Nat'l Bank v. Yorkville Bank, 122 Misc. 616, 204 N.Y.S. 621, *aff'd*, 210 A.D. 885, 206 N.Y.S. 879 (1924); United States Mortgage & Trust Co. v. Liberty Nat'l Bank, 112 Misc. 149, 184 N.Y.S. 32 (1920), *aff'd*, 195 A.D. 890, 185 N.Y.S. 957 (1921); BAILEY, *supra* note 18, at § 23.25.

42. Note, *supra* note 13, at 470-71, n.288; HART & WILLIER, [1976] BENDER'S U.C.C. SERV. (COM. PAPER) § 12.39 (4).

43. U.C.C. § 4-406(5), and comment 7.

44. *Id.*

45. *Id.*

It is generally accepted that section 3-405 may be raised as a defense by a depositary or other collecting bank against a drawee in a warranty suit when the drawee had not asserted this defense against the drawer.[46] Several commentators have concluded that the section 3-406 negligence defenses should also be available to a depositary bank.[47] A few courts, although in dictum, have agreed.[48] But in *Mellon National Bank & Trust Co. v. Merchants Bank*,[49] the court rejected the reasoning of those cases and instead continued the pre-Code law of New York, which held that a payor bank could waive defenses against customers based on negligent preparation or delay in reporting alterations of the instrument and instead proceed against a prior transferor on a warranty theory.[50] Therefore, when the drawee decides not to assert a defense against its drawer based upon section 3-406 negligence, the collecting bank usually must absorb a loss for which it was not primarily responsible.[51] The fact situation that faced the court in *Girard Bank v. Mount Holly State Bank* presented a prime example of this inequitable allocation of loss. In *Girard*, the federal district court had to determine whether New Jersey likewise would permit the drawee bank to waive such defenses against its customers, or would instead force the drawee to assert those defenses before seeking compensation from a collecting bank.

III. *Girard Bank v. Mount Holly State Bank*

A. *Facts and Holding of the Case*

In *Girard* the drawer, Penn Mutual Life Insurance Company, issued on August 4, 1977, a $28,000 check to one of its policy holders, Morris Lefkowitz, as a return of policy premium. The check was drawn on the Girard Bank of Philadelphia and was to be sent to the Penn Mutual agency in New York for distribution to Lefkowitz. The check was never received by Lefkowitz. Instead, it was deposited in the Mount Holly State Bank by one Darlene Payung on August 5. At this time, the check bore the forged

46. *E.g.*, First Pa. Banking and Trust Co. v. Montgomery County Bank & Trust Co., 29 Pa. D. & C.2d 596, 81 MONTG. CO. L. REV. 160 (1962).

47. Whaley, *supra* note 31, at 21; WHITE & SUMMERS, *supra* note 22, at 630 n.53 (arguing that a § 3-406 defense should be available to the depositary bank in a direct suit by the drawer.)

48. Stone & Webster Eng'r. Corp. v. First Nat'l Bank & Trust Co., 345 Mass. 1, 9, 184 N.E.2d 358, 363 (1962); Life Ins. Co. v. Snyder, 141 N.J. Super. 539, 544, 358 A.2d 859, 862 (Dist. Ct. 1976); Canadian Imperial Bank of Commerce v. Federal Reserve Bank, 64 Misc.2d 959, 960, 316 N.Y.S.2d 507, 509 (Sup. Ct. 1970); Society Nat'l Bank v. Capital Nat'l Bank, 30 Ohio App. 2d 1, 7, 281 N.E.2d 563, 566-67 (1972).

49. 15 U.C.C. Rep. Serv. 691 (S.D.N.Y. 1972) (not otherwise reported).

50. Official Comment 7 to U.C.C. § 4-406 indicates that the section was intended to overrule the holding of cases such as Fallick v. Amalgam. Bank, 232 A.D. 127, 249 N.Y.S. 238 (1931). That case allowed the payor bank to waive a defense based upon a forged indorsement of the payee's name. *Id.* at 130, 249 N.Y.S. at 241. The *Mellon* court, however, relying upon the language of Official Comment 1 of section 4-406, interpreted *Fallick* as also allowing a waiver of a defense based upon a delay in reporting material alterations, and held that only this defense was overruled by § 4-406. 15 U.C.C. Rep. Serv. at 694.

51. For a discussion of the unavailability of suit by a depositary bank against a negligent drawer, *see* text accompanying notes 101-22 *infra*.

signature of the payee as an indorsement. Upon deposit, Ms. Payung also endorsed the check.[52]

Mount Holly sent the check through normal banking channels to the Central Penn National Bank, which presented it for payment to the drawer, Girard. Mount Holly received the full amount of the check from Central Penn, which was paid by Girard.[53]

On approximately August 19th, the New York agency of Penn Mutual notified its Philadelphia office that the check had not been received. On the same day, Mount Holly and Girard also were notified of the nonreceipt. Mount Holly immediately froze Ms. Payung's account, which by then had dwindled to $5600.[54]

Girard bank brought this action against Mount Holly in the United States District Court for New Jersey claiming that Mount Holly had breached its presentment warranty of good title to the instrument.[55] Mount Holly impleaded Ms. Payung and Penn Mutual, both of whom filed cross-claims against the other. Girard then sought summary judgment against Penn Mutual for the full amount of the check, and Penn Mutual sought summary judgment dismissing Mount Holly's claim against it.[56] The court, which had jurisdiction through diversity of citizenship,[57] applied New Jersey law.[58]

The court properly recognized that the forged indorsement of the payee's signature prevented subsequent parties, here Mount Holly, from obtaining good title to the check. Therefore, on presentment of the check for payment by Central Penn, Mount Holly breached its warranty of good title to Girard.[59] Absent an effective defense by Mount Holly, Girard should have been able to recover from Mount Holly for payment of the check.[60]

Mount Holly raised two major defenses.[61] It first claimed that section 3-405(1) (C) of the Code rendered the forged indorsement effective when the agent or employee of the drawer, here Ms. Payung, supplied the name of the payee to the drawer while intending that the payee have no interest in the instrument. Had the forged indorsement been effective, title would

52. 474 F.Supp. at 1229.

53. *Id.*

54. *Id.*

55. U.C.C. § 4-207 (1) (a).

56. 474 F.Supp. at 1229-30.

57. *Id.* at 1230.

58. *Id.* at 1230, 1237-38.

59. *See* notes 21-23 and accompanying text *supra.*

60. *Id.*

61. 474 F.Supp. at 1231-36. A third defense was raised by Mount Holly. It argued that Girard did not assert a claim for breach of warranty within a reasonable time after learning of the breach and Mount Holly's liability was thereby discharged to the extent of any loss caused by such delay. U.C.C. § 4-207(4). The court concluded, however, that no genuine issue of material fact was raised that would preclude summary judgment on this issue. The report indicates that Mount Holly and Girard both learned of the missing check on the same day, August 19th. 474 F.Supp. at 1231.

have passed to subsequent takers by the forgery, and Mount Holly would not have breached its warranty of good title. Mount Holly asserted that it was able to show that the check made payable to Lefkowitz was stolen by an employee of Penn Mutual.[62] It was not disputed, however, that Penn Mutual intended to pay the check to the true Lefkowitz. The dishonest employee therefore had not supplied the name of Lefkowitz to his employer intending that the named payee not have an interest in the check. Furthermore, the New Jersey courts had held that section 3-405(1) (C) is not applicable when checks in payment of a true debt of the employer are converted by an employee.[63] Consequently, the *Girard* court held that section 3-405 provided no defense to Mount Holly.[64]

Mount Holly argued additionally that section 4-406(5) provided it with an effective defense against Girard's breach of warranty claim.[65] It first argued that the forged indorsement was an "alteration" of the instrument within the meaning of section 4-406(1).[66] The failure of Penn Mutual to exercise reasonable care in reporting this alteration would, according to Mount Holly, give Girard a valid defense against Penn Mutual.[67] Because Girard had failed to assert this defense, it would be

62. 474 F.Supp. at 1229.

63. Snug Harbor Realty Co. v. First Nat'l Bank, 105 N.J. Super. 572, 253 A.2d 581 (App. Div. 1969), *Aff'd per curiam*, 54 N.J. 95, 253 A.2d 545 (1969).

64. 474 F. Supp. at 1232.

65. *Id.* U.C.C. § 4-406 reads as follows:

§ 4-406. Customer's Duty to Discover and Report Unauthorized Signature or Alteration

(1) When a bank sends to its customer a statement of account accompanied by items paid in good faith in support of the debit entries or holds the statement and items pursuant to a request or instructions of its customer or otherwise in a reasonable manner makes the statement and items available to the customer, the customer must exercise reasonable care and promptness to examine the statement and items to discover his unauthorized signature or any alteration on an item and must notify the bank promptly after discovery thereof.

(2) If the bank establishes that the customer failed with respect to an item to comply with the duties imposed on the customer by subsection (1) the customer is precluded from asserting against the bank

(a) his unauthorized signature or any alteration on the item if the bank also establishes that it suffered a loss by reason of such failure; and

(b) an unauthorized signature or alteration by the same wrongdoer on any other item paid in good faith by the bank after the first item and statement was available to the customer for a reasonable period not exceeding fourteen calendar days and before the bank receives notification from the customer of any such unauthorized signature or alteration.

(3) The preclusion under subsection (2) does not apply if the customer establishes lack of ordinary care on the part of the bank in paying the item(s).

(4) Without regard to care or lack of care of either the customer or the bank a customer who does not within one year from the time the statement and items are made available to the customer (subsection (1)) discover and report his unauthorized signature or any alteration on the face or back of the item or does not within 3 years from that time discover and report any unauthorized indorsement is precluded from asserting against the bank such unauthorized signature or indorsement or such alteration.

(5) If under this section a payor bank has a valid defense against a claim of a customer upon or resulting from payment of an item and waives or fails upon request to assert the defense the bank may not assert against any collecting bank or other prior party presenting or transferring the item a claim based upon the unauthorized signature or alteration giving rise to the customer's claim.

66. 474 F. Supp. at 1234.

67. U.C.C. § 4-406(2).

precluded by section 4-406(5) from asserting a warranty claim against Mount Holly.

The court held, however, that under New Jersey law the term "alteration" did not include a forged indorsement.[68] Moreover, the court held that Girard was not required by section 4-406(5) to raise a section 3-406 defense against Penn Mutual in order to preserve a claim against prior transferors for breach of the presentment warranty.[69] In reaching the latter holding the court addressed several major policy problems created by the statutory scheme of loss allocation on forged indorsements. The court recognized that a rule which allowed the drawee to waive section 3-406 defenses and instead sue prior transferors on a warranty theory created a lack of remedy problem for the collecting bank.[70] The bank could not pass the loss to the forger when he is unavailable and the Code provides no mechanism for a collecting bank to transfer the loss to the negligent drawer. Furthermore, allowing the drawee to waive its defense against the drawer based upon the drawer's negligence thwarts the objective of loss allocation by negligence and hinders the effectiveness of Code provisions, such as section 3-406, that are designed to make drawers more careful.[71] Finally, the court recognized that depositary/collecting banks are often in no better position than the drawee to deter forgery of indorsements even when following reasonable commercial standards.[72] The court maintained, however, that the intention of the Code drafters was clearly stated in Official Comment 7 to section 4-406 as making no provision for such a defense for the collecting bank.[73]

Prior cases under both the U.C.C. and pre-Code law apparently had split on the question whether a drawee bank must use all of its available defenses against the drawer before proceeding against the collecting bank for breach of warranty. The pre-Code position in New York was that the warranties of prior collecting banks created absolute obligations on the part of the transferors, which were not affected by the negligence of the drawer.[74] The drawee bank, therefore, did not need to assert negligence

68. 474 F. Supp. at 1233-34. The court supported this holding in four ways: (1) New Jersey Study Comment 1 to § 4-406 asserts that that section does not require the scrutiny of indorsements on returned checks by the drawer; (2) a perceived redundancy in subsections (2) and (4) if forged indorsements were to be encompassed in both of the terms "unauthorized signature" and "alteration"; (3) reliance on Kraftsman Container Corp. v. United Counties Trust Co., 169 N.J. Super. 488, 492, 404 A.2d 1288, 1290 (1979), which held that unauthorized indorsements were not encompassed by § 4-406(1); and (4) reliance on Society Nat'l Bank v. Capital Nat'l Bank, 30 Ohio App. 2d 1, 281 N.E.2d 563 (1972), which held that the term "alteration" in § 4-406(1) did not refer to forged indorsements. 474 F. Supp. at 1234.

69. *Id.* at 1236.

70. *Id.* at 1235. *See* Whaley, *supra* note 31, at 21.

71. 474 F. Supp. at 1235.

72. *Id.*

73. *Id.* at 1236. *See* discussion in note 44 and accompanying text *supra.*

74. Fallick v. Amalgamated Bank, 232 A.D. 127, 130, 249 N.Y.S. 238, 242 (1924); National Sur. Corp. v. Federal Reserve Bank, 188 Misc. 207, 210, 70 N.Y.S.2d 636, 639-40 (New York Mun. Ct.), *aff'd*, 188 Misc. 213, 70 N.Y.S.2d 642 (Sup. Ct. 1946); American Exch. Nat'l Bank v. Yorkville Bank, 122 Misc. 616, 622, 204 N.Y.S. 621, 627, *aff'd*, 210 A.D. 885, 206 N.Y.S. 879 (1924).

defenses against the drawer before suing the collecting banks for breach of warranty. Such a rule, which allows the drawee bank to avoid litigation on the question of the drawer's negligence, was thought necessary to promote the transferability of these instruments in commerce.[75] Some states indicated that forgery losses of this type were a business risk that collecting banks took upon themselves.[76] Other states, however, held that when a drawee bank had valid negligence defenses against a drawer that it failed to assert, it sustained no loss for which it could seek indemnification in a warranty action.[77]

It appeared as if this latter view would prevail under the Code. Indeed, the courts of various states, in dicta, have recognized that the drawee, in effect, has caused its own loss when it fails to assert valid claims.[78] In *Canadian Imperial Bank of Commerce v. Federal Reserve Bank*,[79] a lower New York court expressly held that the drawee must have asserted section 3-406 negligence defenses against the drawer before it could sue prior transferors for breach of the warranty of no material alterations imposed by section 4-207(1) (C).[80] In *Canadian Imperial* a check was altered to raise the face amount by $37,000. The drawee paid the check and then sought reimbursement from prior indorsers.[81] The drawee's motion for summary judgment was denied until discovery proceedings on the question of the drawer's negligence were completed.[82] The court held:

> [I]f plaintiff has a valid defense against the drawer because the drawer was negligent in making the check and if plaintiff has waived that defense or has failed to assert the defense upon request, plaintiff payor bank may not assert its claim based upon the alteration against the defendant collecting banks.[83]

The federal district court in *Mellon National Bank & Trust Co. v. Merchants Bank of New York*,[84] however, rejected the holding of the *Canadian Imperial* case, maintaining that the New York Court of Appeals would not reach the same result. The federal court in *Girard* followed the

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75. United States Mortgage & Trust Co. v. Liberty Nat'l Bank, 112 Misc. 149, 151, 184 N.Y.S. 32, 33 (Sup. Ct. 1920), *aff'd*, 195 A.D. 890, 185 N.Y.S. 957 (1921), *aff'd*, 201 A.D. 838, 192 N.Y.S. 955 (1922).

76. Standard Accident Ins. Co. v. Pellecchia, 15 N.J. 162, 189, 104 A.2d 288, 302 (1954).

77. Merchants Nat'l Bank v. Federal State Bank, 206 Mich. 8, 172 N.W. 390 (1919); Jones Bros. v. Citizens Nat'l Bank, 106 Okla. 162, 164-65, 233 P. 472, 474 (1923).

78. East Gadsden Bank v. First City Nat'l Bank, 50 Ala. App. 576, 581, 281 So.2d 431, 435 (Civ. App. 1973) (defense available when collecting bank is impleaded in a drawer-drawee suit); Stone & Webster Eng'r. Corp. v. First Nat'l Bank & Trust Co., 345 Mass. 1, 9, 184 N.E.2d 358, 363 (1962).

79. 64 Misc.2d 959, 316 N.Y.S.2d 507 (Sup. Ct. 1970).

80. "Each customer or collecting bank who obtains payment or acceptance of an item . . . warrants to the payor bank . . . that . . . (c) the item has not been materially altered. . . ." U.C.C. § 4-207(1).

The defense raised in this case is different from a defense based upon the bank customer's failure to promptly notify the bank of a material alteration in U.C.C. § 4-406(2) and (5).

81. 64 Misc.2d 959, 959-60, 316 N.Y.S.2d 507, 508.

82. *Id.* at 961-62, 316 N.Y.S.2d at 509-510.

83. *Id.* at 961, 316 N.Y.S.2d at 509.

84. 15 U.C.C. Rep. Serv. 691 (S.D.N.Y. 1972) (not otherwise reported).

reasoning of the *Mellon* court and denied such a defense to collecting banks despite countervailing policy considerations.[85]

Because the court was unwilling to allow Mount Holly to assert the defense of Penn Mutual's section 3-406 negligence against Girard in the latter's section 4-207 breach of warranty suit, the court granted summary judgment against Mount Holly in favor of Girard Bank for the amount of the check. Mount Holly thus was left to absorb a loss caused, arguably, by Penn Mutual's own negligence. Under the Code's system of loss allocation there was no manner by which Mount Holly could assert this loss against the negligent party.[86]

B. *Analysis—The Court's Denial of an Action for the Collecting Bank under the U.C.C.*

Placing the loss for forged indorsements upon collecting banks arguably fails to achieve the objectives that are necessary in a system of loss allocation on negotiable instruments. One commentator has suggested that the goal of any system of allocation of forgery losses is to "facilitate good business practices" and to "allocate losses as equitably as possible."[87] To achieve these results courts have suggested four specific objectives of such a system: (1) placing the loss upon the best risk bearer; (2) placing the loss upon the negligent party; (3) uniformity of result in the application of these standards; and (4) promotion of transferability of negotiable instruments.[88] Two additional objectives have been suggested by the Code drafters and other courts: (5) ascertaining liability on or effectiveness of payment by a negotiable instrument as quickly as practicable—"finality of payment"; and (6) avoiding circuity of legal actions.[89]

It is unclear whether allowing liability to fall upon the collecting bank rather than upon the negligent drawer would distribute the loss to the best risk bearing party. Indeed, as the court in *Girard* noted, many large issuers of checks are in an equally good position to insure against forgery losses. Certainly this was true of Penn Mutual Insurance Company and the Mount Holy State Bank. When the drawer is an individual, however, as is often the case, it may be somewhat easier for the depositary bank to absorb the loss.

Placing liability upon the depositary bank does not achieve the objectives of distributing the loss by negligence or uniformity of application. The result is clearly contrary to the objective of allocating loss to the negligent party since the drawee effectively may insulate its drawer

85. *See* notes 52-73 and accompanying text *supra*.

86. The U.C.C. provides for no cause of action based upon negligence. All the Code provisions dealing with negligence are couched in terms of defenses based upon the negligence of the party seeking recovery. *Compare* § 3-406 with §§ 3-407(2), 4-406(2), 4-406(4) and 4-406(5).

87. Note, *supra* note 13, at 433.

88. *Id.* at 433-34 nn. 74-77.

89. *See* U.C.C. § 3-418, and the Comments thereto; Allied Concord Fin. Corp. v. Bank of America Nat'l Trust & Sav. Ass'n, 275 Cal. App.2d 1, 4, 80 Cal. Rptr. 622, 624 (1969).

from the effects of the drawer's own negligence. Nor is uniformity of application realized when the forgery loss is allocated solely on the basis of the drawee bank's unregulated decision to assert, or not assert, a negligence defense against the drawer. The only possible restriction on the drawee's actions is the Code's imposition of the obligation of good faith;[90] this argument, however, has not been discussed in any of the reported cases.

Transferability of negotiable instruments is arguably not promoted by placing a forgery loss upon an innocent party—here a collecting bank observing reasonable commercial standards. Imposing liability in this situation would seem only to lessen the likelihood that a party would agree to transfer the instrument for payment.

The only two valid policy bases for imposing this liability on the collecting bank are promoting finality of payment and avoiding circuity of legal actions. The first would be accomplished by imposing a duty on depositary banks to recognize the signature of the named payee—a duty very similar to that imposed upon drawees to know their customer's signature.[91] Nevertheless, because depositary banks are often in no better position to recognize forgery than later banks, this imposition of liability may be inequitable.

Avoiding circuity of legal actions is obtained only by stopping the flow of liability toward the negligent party at some point—here between the collecting bank and the negligent drawer. This result, however, is arbitrary, especially when based upon the nebulous concept, asserted by some courts, of "lack of privity" between the drawer and the depositary/collecting bank.[92]

A better method would be to require the drawee to assert the negligence defense against the drawer but hold the collecting bank bound by the determination of that issue. A similar solution, called for by one commentator,[93] would make the collecting bank bear the costs of the drawee's litigation, as the collecting bank has breached its good title warranty in any event. Either of these latter solutions could be acomplished under a "vouching-in-warranty" procedure.[94]

The *Girard* court nevertheless held that the Code does not countenance an action for negligence by the depositary bank against the drawer of the check,[95] nor does it require the payor bank to raise a section

90. U.C.C. § 1-203.

91. *See* notes 19-22 and accompanying text *supra*.

92. *See* discussion in notes 101-07 and accompanying text *infra*.

93. Whaley, *supra* note 31, at 21.

94. The common law doctrine of vouching in warranty is supplemented by U.C.C. § 3-803. That section allows a written notice to be given by a defendant in a commercial paper suit by which the defendant tenders the defense of his action to the person who would be answerable over to him. If the person so notified fails to come in and defend he will be bound in any action by the notifier against him by any determination of fact common to the two litigations.

95. 474 F. Supp. at 1238-39.

3-406 defense against the drawer before suing on a section 4-207 presentment warranty.[96] The federal district court in *Girard*, however, predicting New Jersey law, fashioned a solution to the depositary bank's lack of remedy problem that was both innovative and yet consistent with the Code provisions that the New Jersey Legislature had enacted. It allowed the collecting bank to sue the drawer directly for negligence *outside* the Code remedies.[97]

IV. COLLECTING BANK'S DIRECT NEGLIGENCE ACTION AGAINST DRAWER

Prior to *Girard*, court cases uniformly had denied a direct action by a collecting bank against the drawer for the latter's negligence.[98] The earlier cases avoided analysis of the policy issues of loss allocation by imposing artificial barriers of "privity" and "proximate cause."[99] Later cases, both pre-Code and Code, followed the holdings of earlier cases without serious question.[100] Both the *Mellon* and *Girard* courts thought this rule was continued by the terms of the Code; the district court in *Girard*, however, properly considered the objectives of a loss allocation system for forged indorsements and held that the Code would permit development of a common-law negligence action. The court also briefly considered how this new action meshed with the existing Code machinery.

A. *Existence of a Cause of Action*

1. *Pre-Code Position and Rationale*

Although there is a dearth of authority, it appears to have been the pre-Code rule that a drawer's negligence that contributed to a forged indorsement could not be the basis of a claim by the collecting bank that was forced to make good on its warranties of good title to the drawee.[101] The reasons given by courts for this result are several. A Supreme Court of New York explained:

> The real and underlying reason why the negligence of the drawer constitutes no defense to the collecting [banks] are that there is no privity between the

96. *Id.* at 1234-36.

97. *Id.* at 1239-40.

98. *See* text accompanying note 101 *infra.*

99. *See* text accompanying notes 102-07 *infra.*

100. *See* text accompanying notes 108-11 *infra.*

101. Ocala Nat'l Farm Loan Ass'n v. Munroe & Chambliss Nat'l Bank, 89 Fla. 242, 103 So. 609 (1925); Bank of New York v. Public Nat'l Bank & Trust Co., 195 Misc. 812, 82 N.Y.S.2d 694 (Sup. Ct. 1948), *aff'd*, 275 A.D. 932, 90 N.Y.S.2d 701 (1949), *aff'd*, 301 N.Y. 503, 93 N.E.2d 71 (1950); American Exch. Nat'l Bank v. Yorkville Bank, 122 Misc. 616, 204 N.Y.S. 621 (1924), *aff'd*, 210 A.D. 885, 206 N.Y.S. 879 (1924); Mfrs. Bank v. Prudential Ins. Co., 102 Misc. 339, 168 N.Y.S. 913 (Sup. Ct. 1918); Land Title Bank & Trust Co. v. Cheltenham Nat'l Bank, 362 Pa. 30, 66 A.2d 768 (1949); Second Nat'l Bank v. Guarantee Trust & Safe Deposit Co., 206 Pa. 616, 56 A. 72 (1903).

The drawee would, of course, have to recredit its drawers account since, on paying over a forged indorsement it had not paid the item according to its customers' strictest orders. *See* note 14 and accompanying text *supra.*

> drawer and the collecting bank, . . . and the drawer owes to that bank no duty of vigilance, . . . and no act of the collecting bank is induced by any act or representation or admission of the drawer. . . .[102]

Additional reasons given by courts for denying this cause of action were couched in terms finding "lack of privity of contract"[103] or finding that the drawer's negligence was not the "proximate cause" of the collecting bank's loss.[104]

This labeling was merely a substitute for an analysis of the policy reasons for placing liability on a particular party. For example, if "privity of contract" is taken to mean the relationship between parties to a contract,[105] it has no place in a legal analysis based upon the effects of a party's negligent, tortious conduct. But "privity of contract" may also be used to express that "one person is under an obligation to the other."[106] If that is the context in which courts use the phrase when deciding the appropriateness of a collecting bank-drawer suit, then, again, the words are no more helpful to this analysis than to say that the drawer's negligence was not the "proximate cause" of the collecting bank's loss. In both instances the answer is subsumed in the inquiry. All these phrases—whether "lack of duty", "not the proximate cause", or "lack of privity"—merely express the court's opinion that the "policy of the law will [not] extend the responsibility for the conduct to the consequences which have in fact occurred."[107]

The courts in prior decisions thus were merely using terminology to mask their policy decision that the drawer ought not bear the loss caused by forged indorsements.

2. *The Courts under the U.C.C.*—Mellon *and* Girard

Although several pre-Code courts realized that liability might equitably be imposed on the drawer for losses caused by his negligence,[108] the first court decision applying the Code to this issue, *Mellon National*

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102. American Exch. Nat'l Bank v. Yorkville Bank, 122 Misc. 616, 622, 204 N.Y.S. 621, 627 *aff'd*, 210 A.D. 885, 206 N.Y.S. 879 (1924) (citations omitted); *accord*, Fallick v. Amalgamated Bank, 232 A.D. 127, 249 N.Y.S. 238 (1931).

103. Fallick v. Amalgamated Bank, 232 A.D. 127, 249 N.Y.S. 238 (1931); Mfrs. Bank v. Prudential Ins. Co., 102 Misc. 339, 168 N.Y.S. 913 (Sup. Ct. 1918).

104. American Exch. Nat'l Bank v. Yorkville Bank, 122 Misc. 616, 204 N.Y.S. 621 (1924), *aff'd*, 210 A.D. 885, 206 N.Y.S. 879 (1924).

105. 4 A. CORBIN, CORBIN ON CONTRACTS § 778 at 28 n.45 (1951).

106. *Id.* at § 778 at 28.

107. W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 42 at 244 (4th ed. 1971); *cf.* L. GREEN, RATIONALE OF PROXIMATE CAUSE 11-43 (1927). *See also* CORBIN, *supra* note 105, § 778 at 28-29; Whaley, *supra* note 31, at 24-25.

108. *See, e.g.*, Bank of New York v. Public Nat'l Bank & Trust Co., 195 Misc. 812, 832, 82 N.Y.S.2d 694, 711 (Sup. Ct. 1948), *aff'd*, 275 A.D. 932, 90 N.Y.S.2d 701 (1949), *aff'd*, 301 N.Y. 503, 93 N.E.2d 71 (1950), *quoting* City of New York v. Bronx County Trust Co., 261 N.Y. 64, 184 N.E. 495: "The doctrine of privity, however, is not so conclusive as it once was. Whether there may be negligence under circumstances which would carry the tort liability of a depositor beyond his contract undertaking (cf. Ultramares Corporation v. Touche, 255 N.Y. 170, 174 N.E. 441, 74 A.L.R. 1139), we do not stop to inquire, for the question is not here."

Bank and Trust Co. v. Merchants Bank of New York,[109] failed to do so. The *Mellon* court relied on the pre-Code New York decisions to decide that there was no duty owing from the drawer to a collecting bank and, hence, no privity between them.[110] As discussed previously,[111] such assertions shed little light on the reasons why a court decides not to impose liability on the drawer, and are not helpful to this analysis. The court also noted that an early draft of section 4-207 contained a provision similar to section 4-406(5),[112] but would have required the drawee bank to assert all negligence defenses against the drawer.[113] Because the New York Law Commission expressed concern regarding the extent of the application of this section, the Code drafters transferred the provision in revised form to Section 4-406, where it now appears as subsection (5).[114] The *Mellon* court apparently considered this to be a disapproval of the enlarged application of the principle.

The *Mellon* court, however, held only that this cause of action did not exist under pre-Code law or under section 3-406 of the Code. Apparently, because the issue was not raised, the court did not consider whether such an action might otherwise be available.[115]

The district court in *Girard* agreed that, for his negligence contributing to a forged indorsement, the drawer of a check incurred no liability to a collecting bank under section 3-406. Its holding, however, was based upon different grounds than that of the *Mellon* court. First, *Girard* decided that a collecting bank is not a holder-in-due-course, a drawee or other payor within the meaning of 3-406. Thus, even if 3-406 could be used as other than just a defensive weapon, a cause of action would not be available to a collecting bank.[116] Second, it noted that Official Comment 5 to section 3-406 indicates that 3-406 does not impose tort liability upon a negligent party.[117] The court nevertheless recognized a common law cause of action for the depositary bank in negligence against the drawer. It noted that no Code provision specifically precluded such an action. In addition, it found that allowing this cause of action would remedy the problem created when a drawee fails to assert the drawer's section 3-406 negligence in an action against it for improper payment[118] and then sues the collecting bank for breach of warranty. Moreover, because this type of action would

109. 15 U.C.C. Rep. Serv. 691 (S.D.N.Y. 1972) (not otherwise reported).

110. *Id.* at 693.

111. *See* text accompanying notes 101-107 *supra*.

112. 15 U.C.C. Rep. Serv. 691, 693-94.

113. SUPPLEMENT NO. 1 TO THE 1952 OFFICIAL DRAFT OF TEXT AND COMMENTS OF THE UNIFORM COMMERCIAL CODE 31-32 (1955).

114. 1956 RECOMMENDATIONS OF THE EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE 146, 163 (1957).

115. 15 U.C.C. Rep. Serv. 691, 695-96.

116. 474 F. Supp. at 1238-39.

117. *Id.* at 1239.

118. *See* note 51 and accompanying text *supra*.

deter fraud and prevent forgery by placing the loss on the responsible party, the court held that the Code section that incorporates supplementary principles of common law, section 1-103, would permit cognizance of this action.[119]

Finally, the *Girard* court compared this new cause of action to another development in several jurisdictions. Although not expressly provided for by the Code, a few states permit a cause of action in conversion by a nonnegligent drawer of a check against a collecting bank who takes the instrument over a forged indorsement. While noting that there is no uniformity on the availability of this action,[120] the *Girard* court recognized that the purpose of such suits is to place liability on the party who could have most easily prevented the loss.[121] Applying the same policy, when the negligent drawer of a check is the one who could most easily have prevented the forgery by its exercise of due care, the *Girard* court thought it proper to place liability upon the drawer.[122]

B. *Parameters of the Cause of Action*

Before examining this new cause of action in light of the goals of a commercial paper loss allocation system, its parameters should be explored. The court in *Girard* limited the availability of this cause of action to the type of drawer's negligence that would give rise to a section 3-406 defense, not the type covered by the provisions of sections 3-405 or 4-406. Furthermore, the court limited the new action to suits on forged indorsements. It expressly did not pass on the propriety of a similar action

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119. U.C.C. § 1-103. Supplementary General Principles of Law Applicable

Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions.

120. *Compare* Central Cadillac, Inc. v. Stern Haskell, Inc., 356 F. Supp. 1280 (S.D.N.Y. 1972); California Mill Supply Corp. v. Bank of America Nat'l Trust & Sav. Ass'n, 36 Cal. 2d 334, 223 P.2d 849 (1950); Gregory-Salisbury Metal Products, Inc. v. Whitney Nat'l Bank, 160 So. 2d 813 (La. Ct. App. 1964); Stone & Webster Eng'r. Corp. v. First Nat'l Bank & Trust Co., 345 Mass. 1, 184 N.E.2d 358 (1962); First Nat'l Bank v. North Jersey Trust Co., 18 N.J. Misc. 449, 14 A.2d 765 (Sup. Ct. 1940); Life Ins. Co. v. Snyder, 141 N.J. Super. 539, 358 A.2d 859 (Dist. Ct. 1976); and Lavanier v. Cosmopolitan Bank & Trust Co., 36 Ohio App. 285, 173 N.E. 216 (1929) *with* Sun 'N Sand, Inc. v. United Cal. Bank, 21 Cal.3d 671, 148 Cal. Rptr. 329, 582 P.2d 920 (1978); Allied Concord Fin. Corp. v. Bank of America Nat'l Trust & Sav. Ass'n, 275 Cal. App.2d 1, 80 Cal. Rptr. 622 (1969); Gustin-Bacon Mfg. Co. v. First Nat'l Bank, 306 Ill. 179, 137 N.E. 793 (1922); Sidles Co. v. Pioneer Valley Sav. Bank, 233 Iowa 1057, 8 N.W.2d 794 (1943); Home Indem. Co. v. State Bank, 233 Iowa 103, 8 N.W.2d 757 (1943); Railroad Bldg., Loan & Sav. Ass'n v. Bankers Mortgage Co., 142 Kan. 564, 51 P.2d 61 (1935); Levin v. Union Nat'l Bank, 224 Md. 603, 168 A.2d 889 (1961); Underpinning & Foundation Constructors, Inc. v. Chase Manhattan Bank, 46 N.Y.2d 459, 386 N.E.2d 1319, 414 N.Y.S.2d 298 (1979); Commonwealth v. Nat'l Bank & Trust Co., 46 Pa. D. & C.2d 141 (C.P. 1966); and Commercial Ins. Co. v. First Security Bank, 15 Utah 2d 193, 389 P.2d 742 (1964).

121. 474 F. Supp. at 1240, *quoting* Underpinning & Foundation Constructors, Inc. v. Chase Manhattan Bank, 46 N.Y.2d 459, 468, 386 N.E.2d 1319, 1323, 414 N.Y.S.2d 298, 302 (1979).

122. 474 F. Supp. at 1240. A Louisiana appellate court has recently allowed a negligence action to be brought against a drawer by a person in the position of a collecting bank. Koerner & Lambert v. Allstate Ins. Co., 374 So.2d 179 (La. App. 1979). In a confused opinion the court held that section 3-406 precluded the drawer from asserting the plaintiff's breach of warranty. The court did not address the question of the propriety of a negligence action against the drawer in its opinion.

based upon a forged drawer's signature.[123] In addition, the court noted that the depositary bank must have exhausted all attempts to obtain redress from the forger himself before this negligence action could be instituted.[124]

C. *Effect of the Action in Attaining Objectives of a Risk Allocation System.*

Although the new cause of action remedies some of the deficiencies in the present system of loss allocation and attains several of the objectives of such a system, there remain several situations in which loss allocation objectives would be thwarted. Allowing the depositary bank to pass its loss from the forged indorsement to the negligent drawer should promote the transferability of negotiable instruments in modern commerce. If a collecting bank exercising reasonable care[125] realizes that it will not bear losses caused by someone else, it should be much less worried about accepting these items for collection. How great an effect this would have on the commercial world is uncertain, as the collecting bank must still bear many of the costs of litigating and proving the negligence of the drawer.

Although transferability is enhanced, it is not clear whether imposing the loss for forged indorsements upon the negligent drawer will place the loss upon the party best able to bear this risk. A collecting bank would have to spread the loss from the forgery, or the cost of insurance against such a loss, among its customers or its owners. As past cases have suggested, this may be one of the bank's costs of doing business.[126] But it seems no less equitable to force the drawer of the check to bear the costs of these losses. In many instances it will be in a similar position to insure against these losses or to bear them when they are uninsured. Imposing this liability will, however, attain the objective of placing the loss from the forgeries upon the negligent party. To this extent, such a cause of action will serve to reduce these losses by discouraging the drawer's negligent actions.

Such an action does not, however, avoid circuity of legal actions. Indeed, allowing this suit completes the circle of actions that started when the drawer asserted a "not properly payable" claim against his drawee bank. The drawee then sued a collecting bank and the liability passed up along the chain of transferors to the first solvent party after the forger. Now that this party may sue the drawer, the circle is complete. This loss allocation objective would be more readily achieved by requiring the drawee bank to assert the drawer's section 3-406 negligence before proceeding against a collecting bank.[127] As noted above, the court

123. 474 F. Supp. at 1240.

124. *Id.* at 1241-42.

125. *See* the discussion of the effect of the collecting bank's negligence in the text accompanying note 129 *infra*.

126. *See* note 76 *supra*.

127. *See* text accompanying notes 93-94 *supra*; Professor Whaley calls for such a defense to be raised by the drawee. He would have the collecting bank bear the expenses of this litigation since it has breached its § 4-207 warranty. Whaley, *supra* note 31, at 20-21.

decisions have not required assertion of this defense.[128] When third party actions are available, however, the problem of circuity of action is not so great because the liability for the forgery can be resolved in one proceeding.

Nor is finality of payment enhanced by a new action for negligence, since this action against the drawee adds to the uncertainty in the final effect of dealing with bank checks. The additional liability that this cause of action imposes upon drawers, however, occurs only in the instances when previously the drawee bank had an effective defense against the drawer but refused or failed to assert it, instead collecting from its prior transferors. Such a drawer will be prejudiced very little by the minimal delay in learning that its own negligence will be asserted against it in a claim by a collecting bank rather than as a defense to its claim against the drawer.

Although the cause of action partially aids achievement of the objective of uniformity of result in most instances, it does create similar problems of nonuniform application. In most instances, liability is no longer placed upon the nonnegligent collecting bank at the whim of the drawee. As the *Girard* court recognized, however, if both the collecting bank and the drawee are negligent, determining which party will ultimately bear the loss will depend upon whether or not the drawee asserts a negligence defense against its drawer.[129] If the drawee fails to assert a negligence defense against the drawer, the collecting bank will bear the loss as its contributory negligence will preclude it from asserting a negligence action against the drawer. If the drawee does assert a negligence defense, the drawer will bear the loss by the operation of 3-406. Furthermore, if the jurisdiction allows a direct suit by the drawer against the collecting bank either on a warranty or a conversion theory, but fails to allow the collecting bank to assert the drawer's section 3-406 negligence as a counter-claim, liability will fall upon the collecting bank.

V. A Comparison of Two Possible Remedies

The court in *Girard* was faced with two possible methods of transferring liability on forged indorsements from the collecting bank to the negligent drawer. The first was to require the drawee of the check to assert a section 3-406 defense against its negligent drawer in every situation. It decided that no such requirement was mandated by the Code. The court failed to consider whether such a requirement could be developed at common law despite the number of decisions that could have provided a theoretical base for such requirement.[130] Instead it chose to allow the collecting bank to sue the negligent drawer directly once the

128. *See* text accompanying note 49 *supra.*

129. 474 F. Supp. at 1242.

130. *See* text accompanying notes 77-80 *supra.*

collecting bank was unable to pass its warranty liability onto the forger. Although this result also was not provided for under the Code, the court had little difficulty in allowing its development according to common law principles.

The differences in the results of these two solutions deserve consideration. Requiring the drawee to assert all defenses leads to more standardized results since it would not allow the drawee to choose upon whom the loss would fall when both the drawer and the collecting bank are negligent. Instead, the drawer would bear the loss of the forged indorsement unless the jurisdiction allowed a direct action to the drawer against collecting banks but did not allow the collecting bank a section 3-406 defense against the drawer. This solution would also avoid circuity of legal action by stopping the flow of liability in the first instance. Difficulties may arise when the drawee bank is not in the best position to determine the drawer's negligence, but use of the vouching-in-warranty procedure would effectively eliminate this problem.[131] Use of this procedure would also avoid the situation in which the drawee unsuccessfully asserts the drawer's negligence but then must relitigate its proper assertion of that negligence in a subsequent suit against the collecting bank.

Allowing a direct suit by the collecting bank increases the number of legal actions arising out of a single wrongdoing and may require the involvement of a significantly greater amount of judicial resources. When both parties are negligent, liability would be imposed on the collecting bank—a result similar to that which obtained under pre-Code law.[132] In addition, litigation on the central issue of the case, the negligence of the drawer and the collecting bank, would occur between the two most interested parties. Proof of negligence may be more difficult, however, by the greater likelihood that the depositary bank, as opposed to the drawee, will be in a different locality than the drawer.

Finally, requiring the drawee bank to assert a section 3-406 negligence defense against its customer would avoid problems entailed in a direct negligence suit. The Code drafters feared that uncertainty concerning the ultimate loss would cause the litigation ultimately to be decided on the unsatisfactory basis of burden of proof.[133] Because of this fear, they phrased section 3-406 in terms of a preclusion to recovery.[134] When the drawer is met with a negligence defense by the drawee, "the task of pursuing the wrongdoer [would be upon] the negligent party"—a result contemplated by the Code drafters.[135] Although both solutions thus would

131. Whaley, *supra* note 31, at 21.

132. Alternatively, a direct suit may make easier the determination of the amount of each party's liability in a comparative negligence state. *See* Sun 'N Sand, Inc. v. United Cal. Bank, 21 Cal.3d 671, 148 Cal. Rptr. 329, 582 P.2d 920 (1978).

133. U.C.C. § 3-406, comment 5.

134. *See* notes 33-34 *supra*.

135. U.C.C. § 3-406, comment 5.

achieve the objectives of the Code drafters, requiring the assertion of all defenses would achieve the purpose of the Code drafters in the manner contemplated by them.

VI. CONCLUSION

It has been demonstrated that the U.C.C. does leave gaps in its scheme for allocating losses caused by forged indorsements on bank checks. Accordingly, the collecting bank may be forced to absorb losses that it has little opportunity to prevent and that were caused by the negligence of the drawer of the checks. This Case Comment has considered that allocation of loss and determined that the objectives of a negotiable instruments loss allocation system would be better served by placing the loss upon the negligent drawer. Of the two alternative solutions to this problem considered in *Girard*, the federal district court chose to allow a direct suit by the collecting bank against the negligent drawer of a check instead of requiring the drawee bank to assert a section 3-406 defense against its drawer before claiming a breach of the transferor's section 4-207 warranty. Although the new cause of action remedies some of the problems in the present loss allocation scheme, the result sought by the *Girard* court could be better achieved by requiring the drawee to assert all negligence defenses against the drawer. If such a defense is not asserted, the drawee bank has caused its own loss and should not be able to pass that loss back to prior transferors on their presentment warranties. " '[H]e who loveth peril shall perish in it.' . . . [W]here a person has a safe way and abandons it for one of uncertainty, he can blame no one but himself . . . ."[136] Adequate protection against multiple litigation of the same issue could be afforded by use of the Code's vouching-in-warranty procedure. By adopting these additional requirements for the drawee, states will "allocate losses equitably" and "facilitate good business practices" in the use and handling of bank checks.

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136. Armstrong v. Pomeroy Nat'l Bank, 46 Ohio St. 512, 524, 22 N.E. 866, 869 (1889).